

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**

|  | December 31, |            |
|--|--------------|------------|
|  | 2004         | 2003       |
| (in thousands, except share data)  |              |            |
| <b>ASSETS</b>  |              |            |
| Current assets:  |              |            |
| Cash and cash equivalents  | \$ 19,197    | \$ 13,937  |
| Accounts receivable, net of allowance of \$1,290 in 2004 and \$302 in 2003   | 20,652       | 17,394     |
| Accounts receivable-related parties  | 1,682        | 2,822      |
| Other receivables (\$1,049 in 2004 and \$1,017 in 2003 from related parties)   | 1,107        | 1,045      |
| Prepaid expenses   | 2,019        | 2,028      |
| Other assets   | 2,601        | 3,331      |
| Total current assets   | 47,258       | 40,557     |
| Furniture, fixtures, equipment and software development, net   | 13,380       | 11,808     |
| Deferred income taxes  | —            | 15,812     |
| Investment in affiliates   | 1,847        | 395        |
| Goodwill   | 31,511       | 39,580     |
| Other intangibles, net   | 10,032       | 10,405     |
| Other assets   | 3,613        | 3,140      |
| Total assets   | \$ 107,641   | \$ 121,697 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |              |            |
| Current liabilities:   |              |            |
| Accounts payable   | \$ 8,359     | \$ 10,575  |
| Accrued expenses   | 7,342        | 5,522      |
| Current maturities of long-term debt   | 3,769        | 1,318      |
| Deferred income  | 17,637       | 12,879     |
| Book advances  | —            | 48         |
| Total current liabilities  | 37,107       | 30,342     |
| Deferred rent  | 1,388        | 1,178      |
| Long-term debt   | 4,213        | 5,710      |
| Series B-1 Preferred stock, \$.01 par value; 10,000 and none authorized, issued and outstanding at December 31, 2004 and December 31, 2003, respectively (liquidation value of \$10,000) | 9,736        | —          |
| Stockholders' equity   |              |            |
| Preferred stock, \$.01 par value; 4,990,000 shares authorized; none issued and outstanding at December 31, 2004 and 2003   | —            | —          |
| Common stock, \$.01 par value; 100,000,000 shares authorized; 27,569,764 and 27,385,273 issued and outstanding at December 31, 2004 and December 31, 2003, respectively                  | 276          | 274        |
| Additional paid-in capital   | 116,260      | 114,829    |
| Accumulated deficit  | (61,102)     | (30,261)   |
| Accumulated other comprehensive loss   | (237)        | (375)      |
| Total stockholders' equity   | 55,197       | 84,467     |
| Total liabilities and stockholders' equity   | \$ 107,641   | \$ 121,697 |

See accompanying notes.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Operations**

|  | Years Ended December 31,              |                 |                   |
|--|---------------------------------------|-----------------|-------------------|
|  | 2004                                  | 2003            | 2002              |
|  | (in thousands, except per share data) |                 |                   |
| <b>Revenue</b>   |                                       |                 |                   |
| Test Preparation Services  | \$ 74,744                             | \$ 71,719       | \$ 67,930         |
| K-12 Services  | 27,957                                | 21,525          | 10,066            |
| Admissions Services  | 11,084                                | 11,218          | 11,240            |
| <b>Total revenue</b>   | <b>113,785</b>                        | <b>104,462</b>  | <b>89,236</b>     |
| <b>Cost of revenue</b>   |                                       |                 |                   |
| Test Preparation Services  | 23,584                                | 20,809          | 18,516            |
| K-12 Services  | 13,684                                | 8,328           | 3,533             |
| Admissions Services  | 3,385                                 | 2,836           | 2,888             |
| <b>Total cost of revenue</b>   | <b>40,653</b>                         | <b>31,973</b>   | <b>24,937</b>     |
| <b>Gross profit</b>  | <b>73,132</b>                         | <b>72,489</b>   | <b>64,299</b>     |
| <b>Operating expenses</b>  |                                       |                 |                   |
| Selling, general and administrative  | 78,381                                | 65,634          | 65,482            |
| Impairment of goodwill   | 8,199                                 | —               | —                 |
| Impairment of investment   | —                                     | —               | 344               |
| <b>Total operating expenses</b>  | <b>86,580</b>                         | <b>65,634</b>   | <b>65,826</b>     |
| <b>Income (loss) from operations</b>   | <b>(13,448)</b>                       | <b>6,855</b>    | <b>(1,527)</b>    |
| Interest expense   | (693)                                 | (607)           | (624)             |
| Other income   | 435                                   | 1,217           | 325               |
| <b>Income (loss) before (provision) benefit for income taxes</b>             | <b>(13,706)</b>                       | <b>7,465</b>    | <b>(1,826)</b>    |
| (Provision) benefit for income taxes   | (16,707)                              | (3,156)         | 736               |
| <b>Net income (loss)</b>   | <b>(30,413)</b>                       | <b>4,309</b>    | <b>(1,090)</b>    |
| Dividends and accretion on Series-B-1 Preferred Stock                        | (428)                                 | —               | —                 |
| <b>Net income (loss) attributed to common stockholders</b>                   | <b>\$ (30,841)</b>                    | <b>\$ 4,309</b> | <b>\$ (1,090)</b> |
| <b>Basic income (loss) per share</b>   | <b>\$ (1.12)</b>                      | <b>\$ 0.16</b>  | <b>\$ (0.04)</b>  |
| <b>Diluted income (loss) per share</b>                                       | <b>\$ (1.12)</b>                      | <b>\$ 0.16</b>  | <b>\$ (0.04)</b>  |
| <b>Weighted average shares used in computing net income (loss) per share</b> |                                       |                 |                   |
| Basic  | 27,468                                | 27,306          | 27,239            |
| Diluted  | 27,468                                | 27,467          | 27,239            |

See accompanying notes.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity**  
(in thousands)

|  | Common Stock |        | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Income (loss) | Total<br>Stockholders'<br>Equity |
|--|--------------|--------|----------------------------------|------------------------|--|----------------------------------|
|  | Shares       | Amount |                                  |                        |  |                                  |
| Balance at December 31, 2001   | 27,175       | \$ 272 | \$ 113,091                       | \$ (33,480)            | \$ 350   | \$ 80,233                        |
| Exercise of stock options  | 40           | —      | 266                              | —                      | —  | 266                              |
| Stock based compensation   | —            | —      | 256                              | —                      | —  | 256                              |
| Shares issued in connection with acquisition                                 | 46           | 1      | 359                              | —                      | —  | 360                              |
| Comprehensive loss   |              |        |                                  |                        |  |                                  |
| Net loss   | —            | —      | —                                | (1,090)                | —  | (1,090)                          |
| Foreign Currency gain/loss   | —            | —      | —                                | —                      | (176)  | (176)                            |
| Unrealized loss on securities, net of applicable income tax expense of \$420 | —            | —      | —                                | —                      | (551)  | (551)                            |
| Comprehensive loss   | —            | —      | —                                | —                      | —  | (1,817)                          |
| Balance at December 31, 2002   | 27,261       | 273    | 113,972                          | (34,570)               | (377)  | 79,298                           |
| Exercise of stock options, including income tax benefit of \$125             | 124          | 1      | 706                              | —                      | —  | 707                              |
| Stock based compensation   | —            | —      | 151                              | —                      | —  | 151                              |
| Comprehensive income   |              |        |                                  |                        |  |                                  |
| Net Income   | —            | —      | —                                | 4,309                  | —  | 4,309                            |
| Foreign currency gain/loss   | —            | —      | —                                | —                      | 15   | 15                               |
| Unrealized loss on securities, net of applicable income tax expense of \$10  | —            | —      | —                                | —                      | (13)   | (13)                             |
| Comprehensive income   | —            | —      | —                                | —                      | —  | 4,311                            |
| Balance at December 31, 2003   | 27,385       | 274    | 114,829                          | (30,261)               | (375)  | 84,467                           |
| Exercise of stock options  | 121          | 1      | 834                              | —                      | —  | 835                              |
| Shares issued in connection with an equity investment                        | 64           | 1      | 499                              | —                      | —  | 500                              |
| Stock based compensation   | —            | —      | 98                               | —                      | —  | 98                               |
| Dividends and accretion on Series B-1 Preferred Stock                        | —            | —      | —                                | (428)                  | —  | (428)                            |
| Comprehensive loss   |              |        |                                  |                        |  |                                  |
| Net loss   | —            | —      | —                                | (30,413)               | —  | (30,413)                         |
| Foreign currency gain/loss   | —            | —      | —                                | —                      | 138  | 138                              |
| Comprehensive loss   | —            | —      | —                                | —                      | —  | (30,703)                         |
| Balance at December 31, 2004   | 27,570       | \$ 276 | \$ 116,260                       | \$ (61,102)            | \$ (237)   | \$ 55,197                        |

See accompanying notes.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**

|  | Years Ended December 31, |           |            |
|--|--------------------------|-----------|------------|
|  | 2004                     | 2003      | 2002       |
|  | (in thousands)           |           |            |
| Cash flows from operating activities:  |                          |           |            |
| Net income (loss)  | \$ (30,413)              | \$ 4,309  | \$ (1,090) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                          |           |            |
| Depreciation   | 1,609                    | 1,664     | 1,801      |
| Amortization   | 5,393                    | 4,373     | 4,468      |
| Impairment of goodwill   | 8,199                    | —         | —          |
| Impairment of investment   | —                        | —         | 344        |
| Bad debt expense   | 1,521                    | 380       | 655        |
| Valuation allowance for deferred tax assets  | 22,132                   | —         | —          |
| Deferred income taxes  | (5,425)                  | 2,851     | (736)      |
| Stock based compensation   | 98                       | 151       | 256        |
| Other, net   | 219                      | 392       | (2)        |
| Net change in operating assets and liabilities:  |                          |           |            |
| Accounts receivable  | (3,510)                  | (6,664)   | (7,834)    |
| Prepaid expenses   | 9                        | (764)     | (43)       |
| Other assets   | (246)                    | (1,879)   | 256        |
| Accounts payable and accrued expenses  | (359)                    | 4,252     | (2,049)    |
| Deferred income  | 4,758                    | 86        | 4,312      |
| Net cash provided by operating activities  | 3,985                    | 9,151     | 338        |
| Cash flows from investing activities:  |                          |           |            |
| Purchase of furniture, fixtures, equipment and software development                                | (5,208)                  | (4,272)   | (5,878)    |
| Investment in affiliates   | (850)                    | —         | (270)      |
| Purchase of franchises and other businesses, net of cash acquired                                  | (130)                    | (568)     | (1,393)    |
| Stockholder loan   | —                        | —         | (400)      |
| Notes receivable   | 400                      | 717       | 1,123      |
| Additions to capitalized K-12 content, capitalized course costs and other assets                   | (2,518)                  | (1,706)   | (1,851)    |
| Net cash used in investing activities  | (8,306)                  | (5,829)   | (8,669)    |
| Cash flows from financing activities:  |                          |           |            |
| Repayment term loan, net   | —                        | —         | (50)       |
| Proceeds from credit facility  | 2,000                    | —         | —          |
| Capital lease payments   | (555)                    | (274)     | (204)      |
| Dividends and accretion on Series B-1 Preferred Stock  | (374)                    | —         | —          |
| Proceeds from the sale of Series B-1 Preferred Stock, net of issuance costs                        | 9,682                    | —         | —          |
| Notes payable related to acquisitions  | (1,779)                  | (1,656)   | (1,653)    |
| Proceeds from exercise of options  | 752                      | 582       | 266        |
| Payment of credit facility deferred financing costs  | (145)                    | —         | —          |
| Net cash provided by (used in) financing activities  | 9,581                    | (1,348)   | (1,641)    |
| Net increase (decrease) in cash and cash equivalents   | 5,260                    | 1,974     | (9,972)    |
| Cash and cash equivalents, beginning of period   | 13,937                   | 11,963    | 21,935     |
| Cash and cash equivalents, end of period   | \$ 19,197                | \$ 13,937 | \$ 11,963  |
| Supplemental disclosures of cash flow information  |                          |           |            |
| Cash paid during the year for:   |                          |           |            |
| Interest   | \$ 564                   | \$ 462    | \$ 629     |
| Equipment acquired through capital leases  | \$ 1,276                 | \$ 595    | \$ 229     |

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

**1. Nature of Business and Significant Accounting Policies**

*Business*

The Princeton Review, Inc. and its wholly owned subsidiaries, as well as the Company's national advertising fund (together, the "Company"), are engaged in the business of providing courses that prepare students for college, graduate school and other admissions tests. The Company, through Princeton Review Operations, LLC, provides these courses in various locations throughout the United States and Canada and over the Internet. As of December 31, 2004, the Company had seven franchisees operating approximately 17 offices under the Princeton Review name in the United States and approximately 31 offices abroad operated by franchisees in 19 additional countries. The Company also sells support materials and equipment to its franchisees, authors content for various books and software products published by third parties, sells marketing and web-based products to higher education institutions, operates a Web site providing education-related content and provides a number of services to K-12 schools and school districts to help them measurably improve academic performance.

*Principles of Consolidation*

The accompanying consolidated financial statements include the accounts of The Princeton Review, Inc. and its wholly owned subsidiaries. All significant intercompany transactions and balances are eliminated in consolidation.

*Cash and Cash Equivalents*

As of December 31, 2004 and 2003, cash and cash equivalents consist of investments in securities issued or guaranteed by the U.S. government, its agencies or instrumentalities, which have maturities of 90 days or less at the date of purchase. As of December 31, 2004 approximately 90% of the Company's cash and cash equivalents were on hand at two financial institutions. As of December 31, 2003 approximately 85% of the Company's cash and cash equivalents were on hand at one financial institution.

*Accounts Receivable and Allowance for Doubtful Accounts*

The Company provides credit, in the normal course of business, to its customers. The Company maintains an allowance for doubtful customer accounts for estimated losses that may result from the inability of the Company's customers to make required payments. That estimate is based on a variety of factors, including historical collection experience, current economic and market conditions, and a review of the current status of each customer's trade accounts receivable. The Company charges actual losses when incurred to this allowance.

*Inventories*

Inventories consist of program support equipment, course materials and supplies. All inventories are valued at the lower of cost (first-in, first-out basis) or market.

*Furniture, Fixtures and Equipment*

Furniture, fixtures and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets principally ranging from three to seven years. Leasehold improvements are amortized using the straight-line method over the lesser of the lease term or its estimated economic useful life.

*Software and Web Site Development*

The Company accounts for internal use software development in accordance with the provisions of the American Institute of Certified Public Accountants Statement of Position ("SOP") 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* and Emerging Issues Task Force ("EITF") 00-2, *Accounting for Web site Development Costs*.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

For the years ended December 31, 2004, 2003 and 2002, the Company expensed approximately \$3.8 million, \$2.3 million and \$3.6 million, respectively, of product development costs that were incurred in the preliminary project stage under SOP 98-1. For the years ended December 31, 2004 and 2003, the Company capitalized approximately \$3.2 million and \$2.8 million, respectively, in product and web site development costs under SOP 98-1 and EITF 00-2. For the years ended December 31, 2004, 2003 and 2002, the Company recorded related amortization expense of approximately \$2.8 million, \$2.4 million and \$2.6 million, respectively. As of December 31, 2004 and 2003, the net book value of these capitalized product and web site development costs were \$5.3 million and \$4.9 million, respectively. These capitalized costs are amortized using the straight-line method over the estimated useful life of the assets ranging from 12 to 60 months.

*Goodwill, Capitalized Course Costs, Capitalized K-12 Content and Other Intangible Assets.*

Goodwill represents the excess purchase price of acquired businesses over the estimated fair value of net assets acquired.

Territorial marketing rights represent rights contributed by our independent franchisees to our former subsidiary, Princeton Review Publishing, L.L.C., in 1995 in exchange for membership units of Princeton Review Publishing, L.L.C. to allow the marketing of the Company's products on a contractually agreed-upon basis within the franchisee territories. Without these rights, the Company would be prohibited from selling its products in these territories due to the exclusivity granted to the franchisees within their territories. Should a franchisee decide not to renew its franchise agreement, which is unlikely unless there is a sale of the franchise back to the Company, these rights would remain with the Company. Since no legal, regulatory, contractual, competitive, or other factors limit the useful life of territorial marketing rights, the Company has deemed these intangible assets to have indefinite lives. Goodwill and territorial marketing rights were amortized on a straight-line basis until December 31, 2001, after which such amortization ceased upon the adoption of Statement of Financial Accounting Standards ("SFAS") 142. Accordingly, the Company's goodwill and territorial marketing rights that are deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests. Accumulated amortization at the time of adoption of SFAS 142 was \$2.3 million.

Capitalized course costs include certain expenditures incurred by our Test Preparation Services division to develop test preparation courses and consist primarily of amounts paid to consultants and salaries of employees hired to develop course materials and curriculum. Course costs are capitalized only when a course is first developed or there is a major revision to a course or significant re-write of the course materials or curriculum, for example, when the related test changes. The amortization period for these costs is five years, based upon the average life cycle of the related standardized tests. Amortization of these capitalized course costs commences with the realization of course revenues. The cost of minor enhancements or annual updates to the curriculum and materials is expensed as incurred.

Capitalized K-12 content includes certain expenditures incurred by our K-12 Services division to produce questions and lessons primarily for math, reading and language arts subjects typically taught in grades one through 11 and consist primarily of amounts paid to consultants and salaries of employees hired to produce these questions or lessons. These questions or lessons are used in numerous products sold by the K-12 Services division, including the Homeroom subscription service, printed materials and live instruction products. Only expenditures for questions or lessons that allow the Company to enter into new markets, such as new geographic areas or grades, or that significantly enhance the marketability of the Company's products, such as a new subject area, are capitalized. The amortization period for these costs is seven years, based on numerous factors, including the average lives of similar products and the cycle of major changes in educational philosophies and methodologies as reflected by the adoption cycles of state tests and textbooks. Amortization of these capitalized K-12 content costs commences when the questions or lessons are available for use. The cost of planning, marketing and maintenance related to this content is expensed as incurred, as is the cost of design and feasibility work.

Publishing rights primarily consist of amounts paid in 1995 to certain co-authors to buy out their rights to future royalties on certain books, including *Cracking the SAT/PSAT*, *Cracking the LSAT*, *Cracking the GRE*, *Cracking the GMAT*, *The Best 357 Colleges* and *Word Smart*. These books are primarily current reference materials that are updated every one or two years. In 2004, the Company collected approximately \$1.2 million in royalties from the publisher of these books. Publishing rights are being amortized on a straight-line basis over 25 years.

Franchise costs represent the cost of franchise rights purchased by the Company from third parties and are amortized using the straight-line method over the remaining useful life of the applicable franchise agreement.

Customer lists were purchased by the Company from Embark.com, Inc. ("Embark") in 2001 and consist primarily of academic institution customers of the Company's Admissions Service division. At the time of the acquisition, an independent party completed a valuation of the customer list using a discounted cash flow analysis and assumed an eight percent annual loss of customer revenues. Customer lists are amortized on a straight-line basis over 10 years.

Other intangible assets are amortized on a straight-line basis over their useful lives: Three to 20 years for trademarks/tradenames and three to 20 years for non-compete agreements.



**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

See Note 5 for further information with respect to the Company's goodwill and other intangible assets.

*Impairment*

*Goodwill and Territorial Marketing Rights*

As noted above, the Company adopted SFAS 142, "Goodwill and Other Intangible Assets," under which goodwill and territorial marketing rights are no longer amortized but instead goodwill and territorial marketing rights are assessed for impairment annually. In making this assessment, management relies on a number of factors including operating results, business plans, economic projections, anticipated future cash flows, and transactions and market place data. Goodwill is assigned to specific reporting units and is reviewed for possible impairment at least annually or more frequently upon the occurrence of an event or when circumstances indicate that a reporting unit's carrying amount is greater than its fair value. During the fourth quarter of 2004, the Company completed its annual assessment for impairment and determined that the carrying amount of goodwill for one of its reporting units exceeded its fair value. As a result of the second step analysis, a goodwill impairment of approximately \$8.2 million was recognized.

*Long-Lived Assets*

The Company reviews its long-lived assets, which excludes goodwill and territorial marketing rights, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If such review indicates that an asset may not be recoverable, an impairment loss is recognized for the excess of the carrying amount over the fair value of an asset to be held and used or over the fair value less cost to sell an asset to be disposed. During 2004, no impairment charge was required.

*Investments in Affiliates*

The Company values its investments in affiliate companies in which it has a less than 50% ownership interest and can exercise significant influence using the equity method of accounting. Investments in affiliate companies in which the Company has a less than 20% ownership interest and does not have the ability to exercise significant influence are accounted for using the cost method of accounting.

*Deferred Income*

Deferred income represents tuition and customer deposits (which are refundable prior to the commencement of the program), college marketing fees and subscription services, professional development fees and fees for printed materials. Tuition is applied to income ratably over the periods in which it is earned, generally the term of the program. College marketing fees and subscription fees are applied to income ratably over the life of the agreements, which typically range from one to two years. Fees for professional development and printed materials are recognized as the services and products are delivered.

*Revenue Recognition*

The Company recognizes revenue from the sale of products and services as follows:

*Course and Tutoring Income*

Tuition and tutoring fees are paid to the Company and recognized over the life of the course.

*Book, Software and Publication Income and Expenses*

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

The Company recognizes revenue from both performance-based fees such as marketing fees and royalties and delivery-based fees such as advances, copy editing fees, workbook development and test booklet fees and books sold directly to schools. Performance-based fees, which represent royalties on books and software sold, are recognized when sales reports are received from the publishers. Delivery-based fees are recognized upon the completion and acceptance of the product by the publishers and/or customers. Until such time, all costs and revenues related to such delivery-based fees are deferred. Book advances are recorded as liabilities and deferred book expenses are included in other current assets.

*Royalty Service Fees*

As consideration of the rights and entitlements granted under franchise agreements, which entitle the franchisees to provide test preparation services utilizing the Princeton Review method in their licensed territories, the franchisees are required to pay to the Company a monthly royalty service fee equal to 8% of the franchise's gross receipts collected during the preceding month. In addition, these fees include a per student fee charged to the Company's franchisees for use by their students of the Company's supplemental online course tools. The Company's franchisees' contributions to the advertising fund are also recognized by the Company as royalty revenue (see Note 8). Under the terms of the franchise agreements, the Company has the right to perform audits of royalty service fees reported by the franchisees. Any differences resulting from an audit, including related interest and penalties, if any, are recorded upon the completion of the audit when such amounts are determinable.

*Course Materials and Other Products*

The Company recognizes revenue from the sale of course materials and other products to the independently owned franchises upon shipment.

*Lead Generation Fees*

The Company recognizes revenue from lead generation fees as the service is delivered to these institutions.

*College Marketing and Subscription Fees*

The Company recognizes revenue from subscription fees for web-based services over the life of the contract, which is typically one to two years.

*Transaction Processing Fees*

The Company recognizes revenue from transaction processing fees, such as web-based school application fees, as the transactions are completed.

*Multiple-deliverable contracts*

Certain of the Company's customer contracts represent multiple-element arrangements, which may include several of the Company's products and services. Multiple-element arrangements are assessed to determine whether they can be separated into more than one unit of accounting. A multiple-element arrangement is separated into more than one unit of accounting if all of the criteria in EITF 00-21 are met. If there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative fair value and the revenue policies described above are then applied to each unit of accounting.

*Other Revenue*

Other revenue consists of miscellaneous fees for other services provided to third parties primarily for assessment tests, authoring questions, advertising, training and professional development fees, which are recognized as the products or services are delivered. Also included in other revenue are college marketing fees, such as newsletter or banner ads, which are recognized ratably over the period in which the marketing services are provided, which is typically one year.



*Revenue Components*

The following table summarizes the Company's revenue and cost of revenue for the years ended December 31, 2004, 2003 and 2002:

|                              |  | Years Ended December 31, |                   |                  |
|------------------------------|--|--------------------------|-------------------|------------------|
|                              |  | 2004                     | 2003              | 2002             |
|                              |  | (in thousands)           |                   |                  |
| <b>Revenue</b>               |  |                          |                   |                  |
| Services                     |  | \$ 92,718                | \$ 85,602         | \$ 73,996        |
| Products                     |  | 14,066                   | 11,045            | 6,622            |
| Other                        |  | 7,001                    | 7,815             | 8,618            |
| <b>Total Revenue</b>         |  | <b>\$ 113,785</b>        | <b>\$ 104,462</b> | <b>\$ 89,236</b> |
| <b>Cost of Revenue</b>       |  |                          |                   |                  |
| Services                     |  | \$ 33,099                | \$ 25,286         | \$ 20,217        |
| Products                     |  | 6,891                    | 6,159             | 4,353            |
| Other                        |  | 663                      | 528               | 367              |
| <b>Total Cost of Revenue</b> |  | <b>\$ 40,653</b>         | <b>\$ 31,973</b>  | <b>\$ 24,937</b> |

*Foreign Currency Translation*

Balance sheet accounts of the Company's Canadian subsidiary are translated using year-end exchange rates. Statement of operations accounts are translated at monthly average exchange rates. The resulting translation adjustment is recorded as a separate component of stockholders' equity. Foreign exchange gains and losses for all the years presented were not significant. The accumulated balance as a component of comprehensive income was approximately \$221,000 and \$359,000 at December 31, 2004 and 2003, respectively.

*Advertising and Promotion*

The majority of costs associated with advertising and promotion are expensed in the year incurred. Costs related to producing mailers and other pamphlets are expensed when mailed. Due to the seasonal nature of the business, most advertising costs related to mailers and pamphlets are expensed by the end of the year. Total advertising and promotion expense was approximately \$6.4 million, \$7.6 million, and \$9.1 million for the years ended December 31, 2004, 2003 and 2002, respectively.

*Use of Estimates*

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant accounting estimates used include estimates for uncollectible accounts receivable, deferred tax valuation allowances, impairment write downs and amortization lives assigned to intangible assets. Actual results could differ from those estimates.

*Fair Value of Financial Instruments*

For financial instruments including cash and cash equivalents, accounts receivable, other receivables and accounts payable, the carrying amount approximated

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

fair value because of their short maturity. The carrying value of the Company's debt approximated fair value as the interest rates for the debt approximated market rates of interest available to the Company for similar instruments.

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to concentration of credit risk include cash and cash equivalents and accounts receivable arising from its normal business activities. The Company places its cash and cash equivalents with high credit quality financial institutions.

Concentrations of credit risks with respect to accounts receivable are limited due to the large number of entities comprising the payor base, and their dispersion across different states. The Company does not require collateral. At December 31, 2004, two customers accounted for approximately 18% and 10%, respectively, of gross accounts receivable. At December 31, 2003, one customer accounted for approximately 27% of gross accounts receivable.

*Income Taxes*

The Company accounts for income taxes based upon the provisions of SFAS No. 109, *Accounting for Income Taxes*. Under SFAS 109, the liability method is used for accounting for income taxes, and deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities. A valuation allowance is recorded when it is more likely than not that some or all of the deferred tax assets will not be realized.

*Income (Loss) Per Share*

Basic and diluted net income (loss) per share information for all periods is presented under the requirements of SFAS No. 128, *Earnings per Share*. Basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is determined in the same manner as basic net income (loss) per share, except that the number of shares is increased assuming exercise of dilutive stock options, warrants and convertible securities. The calculation of diluted net income (loss) per share excludes potential common shares if the effect is antidilutive.

During certain of the periods presented, stock options and securities convertible into or exercisable for common stock were outstanding that would be dilutive but were excluded because to include them would have been antidilutive (see Note 15).

*Stock options*

The Company accounts for the issuance of stock options using the intrinsic value method in accordance with Accounting Principles Board ("APB") No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Generally for the Company's stock option plans, no compensation cost is recognized in the Consolidated Statements of Operations because the exercise price of the Company's stock options equals the market price of the underlying stock on the date of grant. Had the Company accounted for its employee stock options under the fair-value method of that statement, the Company's net income per share would have been decreased and net loss per share would have been increased to the pro forma amounts indicated:

|   | Years Ended December 31,              |            |            |
|---|---------------------------------------|------------|------------|
|   | 2004                                  | 2003       | 2002       |
|   | (in thousands, except per share data) |            |            |
| Net income (loss) attributed to common stockholders, as reported  | \$ (30,841)                           | \$ 4,309   | \$ (1,090) |
| Total stock-based employee compensation expense determined under fair-value based method for all awards, net of related tax effects | \$ (1,178)                            | \$ (1,326) | \$ (777)   |
| Pro forma net income (loss) available for common stockholders   | \$ (32,019)                           | \$ 2,983   | \$ (1,867) |
| Basic and diluted income (loss) per share, as reported  | \$ (1.12)                             | \$ 0.16    | \$ (0.04)  |
| Basic and diluted income (loss) per share, pro forma  | \$ (1.17)                             | \$ 0.11    | \$ (0.07)  |

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

After the Company's initial public offering, these options were valued using a Black-Scholes option pricing model. The following weighted-average assumptions were used under this method:

| Assumptions             | Years Ended December 31, |      |      |
|-------------------------|--------------------------|------|------|
|                         | 2004                     | 2003 | 2002 |
| Expected life (years)   | 5                        | 4.8  | 5    |
| Risk-free interest rate | 4.25%                    | 4.5% | 4.5% |
| Dividend yield          | 0%                       | 0%   | 0%   |
| Volatility factor       | 66%                      | 76%  | 76%  |

This option-valuation method requires input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because change in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing methods do not necessarily provide a reliable single measure of the fair value of its employee stock options. The effects of applying SFAS 123 in this pro forma disclosure are not indicative of future amounts and additional awards in future years are anticipated. For purposes of pro forma disclosure, the estimated fair value of the equity awards is amortized to expense over the options' vesting period. The weighted average fair value of options granted during the years ended December 31, 2004, 2003 and 2002 was \$4.42, \$2.75 and \$4.74, respectively. As of December 31, 2004, there were approximately 2,134,000 options exercisable with a weighted average remaining contractual life of approximately 7.3 years.

*Adoption of New Accounting Pronouncements*

In December 2004, the FASB replaced SFAS No. 123 with SFAS No. 123R, *Share-Based Payments*, which requires all share based payments to employees, including employee stock options, to be recognized in the income statement based on their fair values effective July 1, 2005. Based on the options outstanding as of December 31, 2004 the Company expects SFAS No. 123R to have a material impact on its Consolidated statements of operations.

*Reclassification*

Certain balances have been reclassified to conform to the current year presentation.

**2. Other Assets**

Other assets (current) consist of the following at:

|                                    | December 31,    |                 |
|------------------------------------|-----------------|-----------------|
|                                    | 2004            | 2003            |
|                                    | (in thousands)  |                 |
| Deferred book costs                | \$ 782          | \$ 529          |
| Inventories                        | 1,054           | 901             |
| Deferred income tax                | —               | 852             |
| Loans to officers, current portion | 190             | —               |
| Loan Receivable                    | 250             | 500             |
| Other                              | 325             | 549             |
|                                    | <u>\$ 2,601</u> | <u>\$ 3,331</u> |

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

Other assets (noncurrent) consist of the following at:

|   | December 31,   |          |
|---|----------------|----------|
|   | 2004           | 2003     |
|   | (in thousands) |          |
| Security deposits                             | \$ 701         | \$ 691   |
| Content and software development in progress  | 1,493          | 745      |
| Loans to officers, including accrued interest | 1,062          | 1,196    |
| Loan receivable                               | 350            | 500      |
| Other   | 7              | 8        |
|   | \$ 3,613       | \$ 3,140 |

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

**3. Furniture, Fixtures, Equipment and Software Development**

Furniture, fixtures, equipment and software development consist of the following at:

|   | December 31,     |                  |
|---|------------------|------------------|
|   | 2004             | 2003             |
|   | (in thousands)   |                  |
| Computer Equipment  | \$ 5,829         | \$ 5,432         |
| Furniture, fixtures and equipment   | 1,662            | 1,529            |
| Computer and phone equipment under capital lease  | 2,902            | 1,624            |
| Automobiles   | 22               | 22               |
| Software and website development - third party  | 2,540            | 1,774            |
| Software and website development - internally developed   | 8,128            | 6,813            |
| Leasehold improvements  | 5,482            | 4,240            |
|   | <u>26,565</u>    | <u>21,434</u>    |
| Less accumulated depreciation and amortization, including \$1,182 in 2004 and \$722 in 2003 of accumulated depreciation for assets under capital leases | 13,185           | 9,626            |
|   | <u>\$ 13,380</u> | <u>\$ 11,808</u> |

**4. Investment in Affiliates**

On June 25, 2004, the Company invested \$625,000 and issued 63,562 shares of the Company's common stock, with an approximate value of \$500,000 at the time of issuance, and incurred approximately \$162,000 of acquisition costs for an approximate 25% equity interest in Oasis Children's Services, LLC ("Oasis"), a privately held company. Oasis works with schools, school systems and communities to operate summer and after-school programs. In conjunction with the investment, Oasis and the Company have agreed to, from time to time, jointly develop, market and sell summer programs for the K-12 market that combine recreational and enrichment programs and activities provided by Oasis with educational programs and activities provided by the Company. The Company accounts for its investment in Oasis using the equity method.

The Company has an ownership interest of approximately 20% in Student Monitor, LLC, a privately held company. At December 31, 2004 and 2003, the Company's investment in this company was approximately \$0 and \$31,000, respectively.

At December 31, 2004 and 2003, the Company's net investment in Tutor.com was \$0, as a result of recording its share of Tutor.com losses. Pursuant to an agreement entered into on December 31, 2003, the Company terminated its strategic relationship with Tutor.com. and sold preferred stock it held in Tutor.com for \$300,000 in cash. As consideration for the termination of certain strategic agreements and the restructuring of certain rights, the Company received an additional \$200,000 in cash and \$500,000 in notes. The Company retains a common stock position in Tutor.com, representing approximately 2.5% of its outstanding equity, which is valued at \$0 as of December 31, 2004.

Through 2002 and 2001, the Company invested \$700,000 in SchoolNet, Inc., a privately held education technology solutions company. The Company currently owns approximately 5% of SchoolNet. The Company maintains a strategic marketing relationship with SchoolNet, through which SchoolNet markets and distributes a version of the Company's Homeroom product called "Homeroom Inside." As of December 31, 2004 and 2003, the value of the Company's investment in SchoolNet was approximately \$356,000, net of an impairment writedown of approximately \$344,000 in 2002. The Company has also contracted with SchoolNet to provide Enterprise Resource Planning software that monitors the use of the Homeroom.com Web site.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

**5. Goodwill and Other Intangible Assets**

The following table summarizes the components of goodwill which is no longer subject to amortization:

|                               | December 31,     |                  |
|-------------------------------|------------------|------------------|
|                               | 2004             | 2003             |
|                               | (in thousands)   |                  |
|                               | Goodwill         | Goodwill         |
| Gross carrying amount         | \$ 33,070        | \$ 41,139        |
| Less accumulated amortization | 1,559            | 1,559            |
|                               | <u>\$ 31,511</u> | <u>\$ 39,580</u> |

The following table summarizes the change in the carrying amount of segment goodwill for the periods indicated:

|                                 | Test<br>Preparation<br>Services | K-12<br>Services | Admissions<br>Services | Other           | Total            |
|---------------------------------|---------------------------------|------------------|------------------------|-----------------|------------------|
|                                 | (in thousands)                  |                  |                        |                 |                  |
| Balance as of December 31, 2002 | \$ 21,861                       | —                | \$ 8,406               | \$ 7,890        | \$ 38,157        |
| Net change from acquisitions    | 1,123                           | —                | 293                    | —               | 1,416            |
| Other                           | 7                               | —                | —                      | —               | 7                |
| Balance as of December 31, 2003 | <u>22,991</u>                   | <u>—</u>         | <u>8,699</u>           | <u>7,890</u>    | <u>39,580</u>    |
| Net change from acquisitions    | 130                             | —                | —                      | —               | 130              |
| Impairments                     | —                               | —                | (8,199)                | —               | (8,199)          |
| Other                           | —                               | —                | —                      | —               | —                |
| Balance as of December 31, 2004 | <u>\$ 23,121</u>                | <u>—</u>         | <u>\$ 500</u>          | <u>\$ 7,890</u> | <u>\$ 31,511</u> |

As a result of the Company's annual evaluation of the impairment of intangible assets, the Company recorded an \$8.2 million charge for the impairment of goodwill related to the 2001 acquisition of Embark. This impairment resulted from the Admission Services division's disappointing operating results in 2004, and while this division continues to operate and expects to generate future cash flows from the sale of its new marketing services, these future cash flows are still uncertain.



**THE PRINCETON REVIEW<sup>16</sup> INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

The following is a summary of other intangible assets:

|   | December 31,          |                          |              |                       |                          |              |
|---|-----------------------|--------------------------|--------------|-----------------------|--------------------------|--------------|
|   | 2004                  |                          |              | 2003                  |                          |              |
|   | (in thousands)        |                          |              |                       |                          |              |
| Subject to Amortization                   | Gross Carrying Amount | Accumulated Amortization | Net          | Gross Carrying Amount | Accumulated Amortization | Net          |
| Franchise costs                           | \$ 283                | \$ 212                   | \$ 71        | \$ 283                | \$ 175                   | \$ 108       |
| Publishing rights                         | 1,761                 | 684                      | 1,077        | 1,761                 | 611                      | 1,150        |
| Capitalized K-12 content                  | 7,732                 | 3,180                    | 4,552        | 6,672                 | 2,116                    | 4,556        |
| Trademark/tradename                       | 338                   | 193                      | 145          | 338                   | 12                       | 326          |
| Non-compete agreements                    | 1,244                 | 1,067                    | 177          | 1,104                 | 715                      | 389          |
| Customer lists                            | 2,700                 | 878                      | 1,822        | 2,700                 | 608                      | 2,092        |
| Capitalized course costs                  | 1,151                 | 444                      | 707          | 592                   | 289                      | 303          |
| <b><u>Not subject to amortization</u></b> | <b>\$ 15,209</b>      | <b>\$ 6,658</b>          | <b>8,551</b> | <b>\$ 13,450</b>      | <b>\$ 4,526</b>          | <b>8,924</b> |
| Territorial marketing rights              |                       |                          | 1,481        |                       |                          | 1,481        |
|   |                       |                          | \$ 10,032    |                       |                          | \$ 10,405    |

|                                 | (in thousands) |
|---------------------------------|----------------|
| Aggregate amortization expense: |                |
| Actual:                         |                |
| 2002                            | \$ 1,461       |
| 2003                            | \$ 1,625       |
| 2004                            | \$ 2,152       |
| Estimate for fiscal year:       |                |
| 2005                            | \$ 1,904       |
| 2006                            | \$ 1,759       |
| 2007                            | \$ 1,632       |
| 2008                            | \$ 1,028       |
| 2009                            | \$ 586         |

## 6. Line of Credit and Long-Term Debt

### Line of Credit

On May 21, 2004, the Company entered into a credit agreement with Commerce Bank, N.A. for a three-year revolving credit facility with a maximum aggregate principal amount of \$5.0 million. The line of credit was secured by the Company's accounts receivable and bore a variable interest rate based on either the prime rate or 150 to 175 basis points over the London Interbank Offered Rate ("LIBOR"), in accordance with the terms of the agreement. As of December 31, 2004, the effective interest rate was 3.9% and \$2.0 million was outstanding.

As of December 31, 2004, the Company was not in compliance with the financial covenants contained in the credit agreement requiring the maintenance of a certain fixed charge, EBITDA and interest coverage ratios. The balance outstanding under the line of credit has been reclassified to current liabilities as a result of such non-compliance. In February 2005, the company repaid the entire balance outstanding and terminated the credit facility.

### Notes Payable

On March 2, 2001, the Company completed its acquisition of Princeton Review of New Jersey, Inc. and Princeton Review of Boston, Inc. The Company financed part of this acquisition with notes to the sellers totaling \$3,625,000, which was outstanding as of

December 31, 2004. This balance is comprised of two notes. The first promissory note of \$3,125,000 is payable as to principal in 20 equal quarterly installments beginning with the 17th calendar quarter following the closing date of the acquisition and bears interest at the rate of 8.25% per year, payable quarterly. The second promissory note for \$500,000 bears interest at the rate of 8.25% per year, payable on a quarterly basis, and is payable as to the entire principal amount four years from its date of issuance.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

In July 2004, the Company repaid the outstanding balance of the note due to T.S.T.S., Inc. in the amount of \$1,475,000. The Company financed the repayment of this note with the line of credit discussed above.

On October 1, 2001, the Company completed its purchase of substantially all of the operating assets of Embark. As part of the assumed liabilities, the Company renegotiated and assumed \$3.4 million in indebtedness that Embark owed to Comdisco, Inc. ("Comdisco"). Amounts outstanding under the loan agreement bore interest at an annual rate of 6.25%. The loan was secured by substantially all of the Company's current and future business assets, including membership interests in its subsidiaries, and was guaranteed by the Company's subsidiaries. The loan was paid in full as of December 31, 2003.

In October 2004, the Company repaid the remaining outstanding balance on the note due to the Princeton Review of St. Louis, Inc., in the amount of \$250,000, which included interest imputed at the rate of 4.8% per annum.

On July 11, 2003, the Company acquired 77% of Princeton Review of North Carolina, Inc with the balance acquired from the minority shareholders on November 13, 2003. The Company financed part of this acquisition with two notes to the sellers in the amount of \$760,000 and \$208,000, including imputed interest at 5% per year, which were outstanding as of December 31, 2004 and 2003. The \$760,000 note is payable in annual installments of \$80,000, including interest, during 2004 and 2005, increasing to \$120,000 in years 2006 through 2010 when the loan is due. The \$208,000 note is payable in annual installments of \$29,714, including interest, in years 2004 through 2010 when the loan is due.

The annual maturities of notes payable and the line of credit as of December 31, 2004 are approximately as follows:

| As of December 31, | Amount<br>Maturing   |
|--------------------|----------------------|
|                    | (in thousands)       |
| 2005               | \$ 3,100             |
| 2006               | 735                  |
| 2007               | 740                  |
| 2008               | 747                  |
| 2009               | 597                  |
| Thereafter         | 446                  |
|                    | <hr/> \$ 6,365 <hr/> |

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

*Capital Lease Obligations*

At December 31, 2004, the Company has leased approximately \$2.9 million of computer and phone equipment under capital leases, all of which are included in fixed assets

The following is a schedule of the future minimum capital lease obligation payments together with the present value of the minimum lease payments at December 31, 2004:

| Year ending December 31,  | (in thousands) |
|---|----------------|
| 2005  | \$ 779         |
| 2006  | 737            |
| 2007  | 274            |
| 2008  | —              |
| 2009  | —              |
| <b>Total</b>  | <b>1,790</b>   |
| Less amounts representing interest (effective rate ranges from 6% to 11%) | 174            |
| <b>Present value of the minimum lease payments</b>                        | <b>1,616</b>   |
| Less current portion of capital lease obligations                         | 669            |
| <b>Long-term portion of capital lease obligations</b>                     | <b>\$ 947</b>  |

*Total Long-Term Debt*

Long-term debt consists of the following at:

|                           | December 31,    |                 |
|---------------------------|-----------------|-----------------|
|                           | 2004            | 2003            |
|                           | (in thousands)  |                 |
| Notes payable             | \$ 6,365        | \$ 6,075        |
| Capital lease obligations | 1,616           | 948             |
| Auto loan                 | 1               | 5               |
|                           | <b>7,982</b>    | <b>7,028</b>    |
| Less current portion      | 3,769           | 1,318           |
|                           | <b>\$ 4,213</b> | <b>\$ 5,710</b> |

**7. Series B-1 Preferred Stock**

On June 4, 2004, the Company sold 10,000 shares of its Series B-1 Preferred Stock to Fletcher International, Ltd. ("Fletcher") for proceeds of \$10,000,000. These shares are convertible into common stock at any time. Prior to conversion, each share accrues dividends at an annual rate of the greater of 5% and the 90-day London Interbank Offered Rate (LIBOR) plus 1.5%, subject to adjustment. Dividends are payable, at the Company's option, in cash or registered shares of common stock. At the time of issuance of the Series B-1 Preferred Stock to Fletcher, each share of Series B-1 Preferred Stock was convertible into a number of shares of common stock equal to: (1) the stated value of one share of Series B-1 Preferred Stock plus accrued and unpaid dividends, divided by (2) the conversion price of \$11.00, subject to adjustment. In accordance with the terms of the agreement with Fletcher, the conversion price was decreased to \$9.9275 per share because effectiveness of the registration statement relating to the Fletcher shares was delayed until December 28, 2004.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

Fletcher may redeem its shares of the Series B-1 Preferred Stock, in lieu of converting such shares, at any time on or after November 28, 2005, for shares of common stock unless the Company satisfies the conditions for cash redemption. If Fletcher elects to redeem its shares and the Company does not elect to make such redemption in cash, then each share of Series B-1 Preferred Stock will be redeemed for a number of shares of common stock equal to: (1) the stated value of \$1,000 per share of Series B-1 Preferred Stock plus accrued and unpaid dividends, divided by (2) 102.5% of the prevailing price of common stock at the time of delivery of a redemption notice (based on an average daily trading price formula). If Fletcher elects to redeem its shares and the Company elects to make such redemption in cash, then Fletcher will receive funds equal to the product of: (1) the number of shares of common stock that would have been issuable if Fletcher redeemed its shares of Series B-1 Preferred Stock for shares of common stock; and (2) the closing price of the common stock on the Nasdaq National Market on the date notice of redemption was delivered. As of June 4, 2014 the Company may redeem any shares of Series B-1 Preferred Stock then outstanding. If the Company elects to redeem such outstanding shares, Fletcher will receive funds equal to the product of: (1) the number of shares of Series B-1 Preferred Stock so redeemed, and (2) the stated value of \$1,000 per share of Series B-1 Preferred Stock, plus accrued and unpaid dividends.

In addition, the Company granted Fletcher certain rights entitling Fletcher to purchase up to 20,000 shares of additional preferred stock, at a price of \$1,000 per share, for an aggregate additional consideration of \$20,000,000. The agreement with Fletcher provides that any shares of additional preferred stock will have the same conversion ratio as the Series B-1 Preferred Stock, except that the conversion price will be the greater of (1) \$11.00, or (2) 120% of the prevailing price of common stock at the time of exercise of the rights (based on an average daily trading price formula), subject to adjustment upon the occurrence of certain events. Due to the delay in the effectiveness of the registration statement relating to the Series B-1 Preferred Stock, the conversion price for any such additional series of preferred stock was reduced to the greater of (1) \$9.9275, or (2) 108.3% of the prevailing price of common stock at the time of exercise of the rights. These rights may be exercised by Fletcher on one or more occasions commencing July 1, 2005, and for the 24-month period thereafter, which period may be extended under certain circumstances. The Agreement with Fletcher also provides that shares of additional preferred stock will also be redeemable upon terms substantially similar to those of the Series B-1 Preferred Stock.

During 2004, cash dividends in the amount of \$373,611 were paid to the Series B-1 Preferred stockholder.

## **8. Commitments and Contingencies**

### *Advertising Fund*

All domestic franchisees are required to pay a monthly advertising fee to the Company, for contribution to an advertising fund, equal to 2% of their franchisees' gross receipts, as defined, for the preceding month. In accordance with the terms of the franchise agreements, the Company is required to use all advertising fees it receives for the development, placement and distribution of regional and national consumer advertising, designed at its discretion to promote consumer demand for services and products available from the franchisees.

The Company is required to keep separate advertising fund accounting records and to maintain the advertising funds collected from the franchisees in a separate bank account. Franchisee payments to the Company in respect of the advertising fund are recorded in the Company's revenue and the expenses of the advertising fund are recorded in the Company's Selling, General and Administrative Expenses.

**THE PRINCETON REVIEW, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements – (Continued)**

*Office and Classroom Leases*

The Company has entered into various operating leases in excess of one year, primarily office and classroom site locations. Minimum rental commitments under these leases, including fixed escalation clauses, which are in excess of one year, as of December 31, 2004, are approximately as follows:

| Years Ending December 31, | (in thousands)        |
|---------------------------|-----------------------|
| 2005                      | \$ 4,411              |
| 2006                      | 4,141                 |
| 2007                      | 3,970                 |
| 2008                      | 3,533                 |
| 2009                      | 3,037                 |
| Thereafter                | 7,583                 |
|                           | <hr/> \$ 26,675 <hr/> |

Rent expense for the years ended December 31, 2004, 2003 and 2002 was approximately \$8.6, \$7.7 and \$6.9 million, respectively. These amounts include rent expense for the rental of space on a month-to-month basis, as well as those amounts incurred under operating leases for longer periods. Certain leases provide for early termination without penalty.

*Legal Matters*

The Company is party to various litigation matters in the ordinary course of its business which, in the opinion of management, will not result in a material loss to the Company.

*Co-authorship Agreements*

In connection with its publishing agreements, the Company has entered into various co-authorship agreements for the preparation of manuscripts. These agreements require payment of nonrecourse advances for services rendered at various established milestones. The Company did not have any future contractual commitments under the co-authorship agreements for manuscripts not yet delivered for the year ended December 31, 2004, however there were approximately \$30,000 in commitments as of December 31, 2003. In addition, the co-authors are entitled to a percentage of the future royalties earned by the Company, which are first to be offset against such advances. The total costs incurred under these co-authorship agreements by the Company for advances and royalties were approximately \$663,000, \$528,000, and \$367,000 for the years ended December 31, 2004, 2003 and 2002, respectively.

The expense related to co-author payments is accrued monthly. This expense is adjusted based upon actual expenditures paid to the co-authors. These expenditures are a percentage of the royalties paid to the Company by the publisher. Royalties from the publisher are recorded as revenue with the co-author expenditures recorded as expense.